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IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 75-1221

UNITED STATES OF AMERICA, *Petitioner*

v.

CONSUMER LIFE INSURANCE COMPANY

No. 75-1260

FIRST RAILROAD & BANKING COMPANY OF GEORGIA, *Petitioner*

v.

UNITED STATES OF AMERICA

No. 75-1285

UNITED STATES OF AMERICA, *Petitioner*

v.

PENN SECURITY LIFE INSURANCE COMPANY

On Writs of Certiorari to the United States Court of Claims and the United States Court of Appeals for the Fifth Circuit

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BRIEF FOR FIRST RAILROAD & BANKING COMPANY OF GEORGIA

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BRIEF FOR FIRST RAILROAD & BANKING COMPANY OF GEORGIA

COUNTER-STATEMENT OF QUESTIONS PRESENTED

1. Section 801(a) of the Internal Revenue Code of 1954 defines a "life insurance company" as an insurance company whose life insurance reserves comprise more than 50 percent of its "total reserves" as the term is defined in Section 801(c).

A prime insurer (writing both life insurance and accident and health insurance) entered into a Reinsurance Agreement under which it ceded (transferred) a portion of its accident and health premiums and obligations to the reinsurer. Under state law the prime insurer was entitled to deduct from its total reserves the reserves attributable to the ceded premiums and obligations. If the reserves for these ceded policies are not included in total reserves of the prime insurer, its life insurance reserves are more than 50 percent of its total reserves.

The question is whether the District Court was correct in finding that the Reinsurance Agreement was founded on substantial non-tax purposes and should be given effect, with the result that the prime insurer qualified as a "life insurance company," or whether the Court of Appeals was correct in holding that the Agreement should not be given effect for tax purposes because there was no effective transfer of risk under the Agreement except in case of insolvency, and therefore the accident and health reserves must be included in the total reserves of the prime insurer, destroying its qualification to be a "life insurance company."

2. Whether it was proper for the Court of Appeals, under the "clearly erroneous" test of Rule 52(a), F.R. Civ. P., to pay lip service to—but actually to overturn—a square finding by the trial judge that the Reinsurance Treaty involved herein was a "valid business transaction," which had substantial non-tax purposes, was written in terms usual in the industry, and should be recognized for tax purposes.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.)

§ 801(a) *Life Insurance Company Defined.—*

For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance) or noncancellable contracts of health and accident insurance, if—

(1) its life insurance reserves (as defined in subsection (b), plus

(2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,

comprise more than 50% of its total reserves (as defined in subsection (c)).

* * * * * *

§ 801(c) *Total Reserves Defined.—*

For purposes of subsection (a), the term "total reserves" means—

(1) life insurance reserves,

(2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and

(3) all other insurance reserves required by law.

Treasury Regulations

§ 1.801-3 (e) *Unearned premiums.* The term "unearned premiums" means those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums

have been paid in advance. Such term includes all unearned premiums, whether or not required by law.

* * * * * *

§ 1.801-5 *Total Reserves.*

(a) Total reserves defined. For purposes of section 801(a) and § 1.801-3, the term 'total reserves' is defined in section 801(c) as the sum of—

(1) Life insurance reserves (as defined in section 801(b) and § 1.801-4),

(2) Unearned premiums (as defined in paragraph (e) of § 1.801-3), and unpaid losses (whether or not ascertained) (as defined in paragraph (g) of § 1.801-3), not included in life insurance reserves, and

(3) All other insurance reserves required by law.

The term 'total reserves' does not, however, include deficiency reserves (within the meaning of section 801(b)(4) and paragraph (e)(4) of § 1.801-4), even though such deficiency reserves are required by State law. In determining total reserves, a company is permitted to make use of the highest aggregate reserve required by any State or Territory or the District of Columbia in which it transacts business, but the reserve must have been actually held during the taxable year for which the reserve is claimed.

* * * * * *

(b) *Reserves required by law defined.* For purposes of part I, subchapter L, chapter 1, of the Code, the term 'reserves required by law' means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by

statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries.

COUNTER-STATEMENT OF THE CASE

We accept substantial portions of the Government's statement of the case [1] as to No. 75-1260 (*First Railroad & Banking Company of Georgia*), brief pp. 17-23, but it contains inaccuracies and omissions which we correct below. It is important to state that, as noted in the Government's brief at page 19, the critical steps under the Reinsurance Treaty involved here are:

(a) Georgia Life, the Insurer, ceded to Georgia Insurance, the Reinsurer, 60 percent [2] of the premiums paid on the credit accident and health insurance issued by Georgia Life. Georgia Insurance accepted the obligations on that 60 percent of the insurance.

(b) Georgia Insurance established on its books a reserve for the unearned premium liability on that 60 percent share of the insurance.

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[1] Although First Railroad & Banking Company of Georgia was the petitioner in No. 75-1260, it was agreed among the parties that the Government would file the opening brief in all three cases which have been consolidated here. The Government filed a single brief covering all three cases. This, then, is First Railroad's answering brief on the merits.

[2] The Government uses the 60 percent figure throughout. Actually, while the Reinsurance Treaty originally contained a 60 percent figure (see P. 12, App. 185 at 192); it was amended in less than a year to state 70 percent (App. 194), and it remained at 70 percent thereafter. We use the figure of 60 percent throughout this brief only to avoid confusion.

(c) Georgia Life, as permitted by state law, took a corresponding deduction from its own unearned premium reserve.

(d) The Reinsurance Treaty was approved by the Insurance Commissioner of the State of Georgia. The State insurance officials did not, after periodic examinations of Georgia Life's books, challenge its treatment of reserves.

We correct the Government's statement of the case as follows:

1. On page 18 the Government says:

> "*In order to reduce its A & H reserves,* Georgia Life entered into a reinsurance agreement with its parent, First of Georgia Insurance Company (Georgia Insurance), on December 31, 1961." (Emphasis added)

The first phrase is a misstatement of the facts, making it appear that the reinsurance arrangement had a single purpose—a tax purpose. The District Judge, sitting without a jury, made Findings of Fact (binding by virtue of Rule 52(a), F.R. Civ. P.) reciting a large number of "substantial non-tax purposes for entering into the arrangement." (Pet. App. B 14a) The District Judge found as follows (pp. 14a-15a):

> "Despite this transfer of minimal risk under the Reinsurance Treaty, there were substantial non-tax purposes for entering into the arrangement. These mainly had to do with the limited surplus position of Georgia Credit Life as well as the limited experience in the credit accident and health business of its managerial team. When Georgia Credit Life was formed by Georgia Insurance in 1958, Georgia Insurance was precluded by state law from entering into the credit life

business. Georgia Insurance's agency force, however, was demanding an expanded coverage which would include credit life as well as credit accident and health for its customers; thus, the necessity of forming a subsidiary to provide these services. Shortly after Georgia Credit Life began providing these services, the management realized that its capital structure would be increasingly burdened by the substantial volume of business which the company was writing because of the deficits caused by provisional payments of commissions to the agents. As the volume of business increased the ratio of net written premiums to policyholder surplus increased. Reduction of this ratio became necessary if the company was to continue expansion through new business which would further burden the surplus.

"This reduction was accompanied by entering into the subject Treaty, the terms of which provided for an effective transfer of a portion of the burden to Georgia Insurance's capital structure. The result was that Georgia Credit Life was thereafter capable of, and in fact accomplished, a threefold increase in the volume of credit accident and health business. This rapid expansion was desirable to increase profits and additionally, to provide the inexperienced management team with a firmer basis for loss prediction by improving the reliability of actuarial averages."

We should explain that the company called "Georgia Credit Life" by the District Judge is the same company (First of Georgia Life Insurance Company) referred to as "Georgia Life" in the Government's brief and in this brief.

The District Judge went on to say (Pet. App. B 15a):

"An additional business purpose for entering into the Treaty was that it tended to insure the solv-

ency of Georgia Credit Life by protecting its surplus from depletion through payment of excessive losses. For in the event of excessive losses, which in reality reinsurance is designed to protect against, 60% (later 70%) of the liability would be satisfied initially from the excess surplus held by Georgia Insurance. Although these losses would eventually be recaptured, the recapture would entail no surplus drain but rather an adjustment to Georgia Credit Life's reinsurance commissions which were calculated with reference to earned premiums. Thus, the capital structure of Georgia Credit Life was insulated against the risk of excessive losses and in such event the company would remain solvent enabling it to recoup commission losses through retroactive adjustment of provisional commissions paid to its agents."

The District Judge also found as follows (Pet. App. B 15a-16a):

> "The subject Treaty also inured to the advantage of the policyholder in that the arrangement subjected the substantial surplus of the parent company to policyholder claims. This was a particularly valuable protection should the subsidiary become insolvent because the insolvency clause of the Treaty, which was required by state law, provided for continued liability of the parent for 60% (later 70%) of the claim. It is noteworthy that this arrangement was approved by the Insurance Commissioner of the State of Georgia whose regulatory function is geared to protection of the policyholder."

Finally, the District Judge (who had said, Pet. App. B 12a, that he was examining the Reinsurance Treaty, "the bona fides of which is in the true sense the subject of this litigation") found as follows:

> "The Reinsurance Treaty in question was under terms comparable to, and patterned after, rein-

surance rates and terms that are usual in the industry between companies dealing at arms length. The advantages accruing to Georgia Credit Life pursuant to the Treaty would have been the same regardless of the reinsurer. The obvious advantage to the parent, Georgia Insurance, was an increase in investment income corresponding to its reinsurance premium."

Another non-tax purpose for entering into the reinsurance agreement, not specifically noted by the District Judge but testified to by the president of Georgia Insurance, Mr. E. Russell Phillips, was that the increased business permitted Georgia Insurance "to show a greater premium production volume" as reported in the standard publications of Alfred M. Best Company (the Dun & Bradstreet of the insurance business, as Mr. Phillips put it), which "was an enhancement to First of Georgia Insurance Company at that time. We were interested in doing this." (App. 68)

2. On page 20 of its brief the Government says: "... petitioner's expert witness conceded that the reinsurance arrangement did not transfer the risk of loss to Georgia Insurance (A. 122-123)." This is a complete misreading of what the witness said, and in fact it seems clear that he testified to precisely the contrary. The witness was Arthur Crooks Eddy, a well-known consulting actuary whose entire experience has been with insurance companies (App. 106-7). He was asked on crossexamination (App. 123): "So this treaty didn't further the basic purpose of reinsurance to spread risk, is that what you are saying?" Mr. Eddy replied, in (apparently) the testimony contemplated by the Government's brief:

"No. No, No. I don't want to answer that question. Now wait, I don't say that the only basic

purpose of reinsurance is to spread the risk or the loss."

Perhaps the Government took the first "No" and interpreted that as an answer to the question, whereas it is obviously not a substantive "No" but only a preliminary to his next sentence, which was (prophetically): "There are many reasons for reinsurance, some of which we have heard discussed here today, other than spreading of risk." Immediately thereafter, Mr. Eddy said: "But there was a spreading of the risks involved in this treaty which I alluded to earlier when I said they could take more lives." (App. 123)

3. On page 21 of its brief the Government says:

> "Zelten [Government's expert witness] was of the opinion that Georgia Life obtained no advantage from the arrangement other than a tax benefit."

This is impermissible "statement of the case." Wholly aside from the fact that Zelten was forced on crossexamination to admit that the reinsurance treaty had at least two genuine business purposes,[3] the Government is precluded by the "business purpose" find-

[3] One purpose involved the uncertain prospect for the Insurer in entering into the new and possibly risky field of accident and health insurance in 1961. Reinsurance offered a "real business purpose just in order to cover the possibility," as Zelten admitted (App. 175). The other purpose was that the reinsurance treaty enabled Georgia Life to expand more rapidly, because of restrictions imposed by state authorities. Zelten testified (App. 176) that: "Yes, the way they were permitted to effect the reinsurance treaty did allow them to expand." The trial judge put it to Zelten in exactly that manner (App. 179): "Yes, your testimony was that the way this reinsurance agreement was treated by these two companies would have permitted Georgia Credit to expand more rapidly. This is what you said." And Zelten agreed.

ings of the District Court from adducing here the contrary testimony of a witness. Rule 52(a), F.R. Civ. P., makes the District Judge's finding binding unless "clearly erroneous." Even the Fifth Circuit did not quarrel with the District Court's findings of fact, thus invoking the "two-court rule," and the Government ought not to be allowed to undermine the trial court's findings by quoting a witness who was repudiated by that court.

4. The Government's statement, p. 21 of its brief, that "Professor Zelten's opinion was corroborated by the earlier testimony of Bobby Steed Clark" is laughably incorrect. The Government puts it that Clark "explained" that the reinsurance arrangement was a surplus aid contract and not a reinsurance contract (pp. 21-22). Not only did the trial judge force Clark (App. 139-141) to admit that the Reinsurance Treaty here was not a surplus aid contract (because it did not provide for provisional ceding commissions to be paid the insurer, the distinguishing sign of a surplus aid contract), but just a short time later Zelten testified (App. 163): "This is not a surplus aid contract. There is no way in the world it will work out that way."

5. The Government (p. 22) quotes Clark as saying that a 1967 Georgia insurance examination report, which stated that the reinsurance agreement appeared to be in good order, was "contrary to all reporting standards and practices" and had been neither accepted nor approved by the Georgia Department of Insurance. This, again, is impermissible statement of the case, in view of the fact that the trial judge found that the arrangement "was approved by the Insurance Commissioner of the State of Georgia" (Pet. App. B 16a); that the reinsurance agreement was "under

terms comparable to, and patterned after, reinsurance rates and terms that are usual in the industry" (p. 16a); and that the transaction "was a valid business transaction" (p. 17a). The trial judge considered the testimony of Clark and Zelten and made findings to the contrary.

SUMMARY OF ARGUMENT

The Government's argument is essentially that the reinsurance agreements involved in these cases are mere contrivances to shift accident and health reserves in order to qualify a company for status as a "life insurance company." As to the so-called "Treaty II" type of reinsurance agreement (under which the Government classifies the *First Railroad* Reinsurance Treaty), meaning an arrangement under which the Insurer cedes a certain percentage of its accident and health policies to a Reinsurer for a commission, and losses are then recaptured by the Reinsurer from the commissions due the Insurer, the Government's case is that these agreements are actually a sham, because of the recapture clause.

As to *First Railroad,* this argument cannot be made. The findings of the District Court, protected by the "clearly erroneous" provision of Rule 52(a), F.R. Civ. P., preclude any such argument. The District Court specifically found that the Reinsurance Treaty in this case was bona fide, was patterned after reinsurance rates and terms that are usual in the industry between companies dealing at arms' length, was entered into for legitimate business purposes, and was a valid business transaction.

The Fifth Circuit, though reversing the District Court, did not quarrel with these findings; instead, it

concurred in them. Accordingly, not only is the "clearly erroneous" rule applicable here, but in addition the "two-court rule" applies. The Government does not tender to this Court any alleged error in the trial court's findings; it merely ignores them. This it may not do.

The Fifth Circuit, in the case below, did not even purport to meet or to struggle with the actual provisions of the statutory provision before the Court. The issue here is whether the Insurer, Georgia Life, qualified as a "life insurance company" under Section 801(a) of the Internal Revenue Code. That section provides a so-called "reserve ratio" test. A company qualifies if its life insurance reserves (which are not an issue here) comprise more than 50 percent of its "total reserves." The term "total reserves" is defined in Section 801(c) to mean (1) life insurance reserves, (2) "unearned premiums," and (3) "all other insurance reserves required by law."

Under the Reinsurance Treaty in this case, the Insurer ceded (transferred) to the Reinsurer 60 percent (later 70 percent) of all of its accident and health policies when written. The premiums for such policies are paid fully in advance, in a single payment, and are said to be "unearned" as to the period of protection to be afforded in the future. The Reinsurer accepted the unearned premiums and the obligations under the policies, and established an unearned premium reserve for that amount. The Insurer then (as permitted by state law) deducted that amount of reserves from the reserves it had been required to set up when it originally received the premiums. The Insurance Commissioner of the state not only approved the Reinsurance Treaty; he also examined this treatment of re-

serves by the two companies and took no exception to it.

Beyond question, if this treatment of reserves was proper, the life insurance reserves of Georgia Life (the Insurer) were more than 50 percent of its "total reserves" and it qualified as a "life insurance company."

Without addressing the specific provisions of the statute at all, without determining that the reserves maintained by the Reinsurer were "unearned premiums" of the Insurer under Section 801(c)(2) or were "other insurance reserves required by law" of the Insurer, the Fifth Circuit held that the reserves of the Reinsurer for the ceded premiums were to be attributed to the Insurer and added to its "total reserves," thus making the life insurance reserves less than 50 percent of its total reserves. The Fifth Circuit's reasoning, not based on the literal provisions of the statute, was that the ultimate risk of loss was on the Insurer, because of the recapture provision of the agreement, and that the intent of Congress was that the "reserves should follow the risk." In employing this risk-attribution test, the First Circuit adopted and followed the rationale of the Seventh Circuit in *Economy Finance Corp.* v. *United States*, 501 F.2d 466 (1974), cert. den., 420 U.S. 947.

The Fifth Circuit and the Government in its brief here have attempted to federalize a matter deliberately left by Congress to the states. Historically and admittedly, the treatment of insurance reserves is for the states to determine. Even the Treasury Regulations involved here confirm that fact. When the state authorities approved the reinsurance agreement involved

here, and accepted the treatment of reserves leading to the deduction by the Insurer from its total reserves, that should have been conclusive for the purposes of Sections 801(a) and 801(c). As the District Judge put it, "the reserves should follow the premiums," which was essentially the position of the state insurance officials interpreting state law.

The Treasury Regulations involved here lead to the same result. Regulation § 1.801-5(a), defining "total reserves," requires that the reserve "must have been actually held" during the taxable year. Regulation § 1.801.5(b) states that "reserves required by law" means reserves "which are reported in the annual statement of the company and accepted by state regulatory authorities as being held for the fulfillment of the claims of policyholders or beneficiaries." Only one company here—the Reinsurer, not the Insurer—fits those Regulations. The Government, however, omits completely to discuss its own Regulations and instead employs non-statutory, non-Regulation, tests.

The burden of the Government's argument as to *First Railroad* is that reinsurance has only one purpose—to shift the risk—and if the Treaty here did not do so, it is not "reinsurance" at all. Without conceding that there was no risk-shifting here, we point out that there is nothing to the Government's basic premise. Reinsurance has many purposes besides risk-shifting, and the District Judge specifically found three major non-tax (insurance) purposes served by the Reinsurance Treaty. The Fifth Circuit did not disagree. The trial court's findings are thus (again) protected by the "clearly erroneous" provisions of Rule 52(a), F.R. Civ. P., and are binding.

The non-statutory "risk-attribution" test sought here by the Government, and actually applied by the Fifth Circuit, which concededly ignores the literal terms of the statute, has caused consternation and confusion in the insurance industry. This Court should restore confidence and certainty by requiring adherence to the statutory provisions that Congress actually wrote.

ARGUMENT

I. The Government's Argument that the Reinsurance Agreement is a Sham Is Precluded by the Findings of the Trial Court

It is clear that the Government's case depends on proving that the reinsurance agreements in these cases are deliberate devices to shift accident and health insurance reserves in order to qualify for life insurance status. The Government begins by quoting from a case speaking of "an elaborate and devious form of conveyance masquerading as a corporate reorganization" (brief, p. 36): it speaks of Treaty II type agreements (in which it includes *First Railroad*) as "an elaborate facade of hypothetical and speculative risk shifting" without risk of loss (p. 65); and this theme runs throughout the brief. The argument is, in short, that the reinsurance agreement in *First Railroad* is a sham.

We have no quarrel with the proposition that sham transactions should be ignored, or that substance governs over form, or any of the other familiar axioms on which the Government has built its brief. It is totally unnecessary to cite cases to that effect. But as to the *First Railroad* case, No. 75-1260, this argument cannot be made. The trial court's findings, protected by Rule 52(a), F.R. Civ. P., are conclusive against the

Government's attack on the bona fides of that agreement.

In *First Railroad* the trial judge, who (sitting without a jury) heard the evidence and determined the facts, began by saying that the "bona fides" of the Reinsurance Treaty "is in the true sense the subject of this litigation." (Pet. App. B 12a) Having laid that down as the matter to be inquired into, the trial judge on the basis of the evidence made findings on which he based his conclusion that the "transaction which is the subject of this litigation, having been found to have been entered into for legitimate business purposes, was a valid business transaction . . ." (Pet. App. B 17a) He found that the transaction was a reinsurance arrangement on terms "comparable to, and patterned after, reinsurance rates and terms that are usual in the industry between companies dealing at arms length." (Pet. App. B 16a) He described three different major non-tax purposes for entering into the arrangement.[4] Having thus established the bona fides of the transaction as a *factual* matter, he proceeded to the legal analysis of these facts.

The Government has, impermissibly, attempted to go behind and undercut these findings of the trial judge, findings which are protected by the "clearly erroneous" mandate of Rule 52(a) of the Federal Rules of Civil Procedure.[5]

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[4] See Pet. App. B 14a-16a. Even the Seventh Circuit in the *Economy Finance* case, so heavily relied upon by the court below, noted the number of non-tax purposes existing in *First Railroad* but absent in *Economy Finance*. See *Economy Finance Corp* v. *United States*, 501 F.2d 466 at 479 (7th Cir., 1974), cert. den., 420 U.S. 947.

[5] Rule 52(a), F.R. Civ. P., reads as follows: "Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses."

Even the Fifth Circuit did not take issue with the District Court's findings; instead, it concurred in them, saying (Pet. App. A 5a): "Nor do we question the validity of everyone's business reasons for establishing this Treaty arrangement . . ." Accordingly, the "two-court rule" applies. As stated in *Pick Mfg. Co.* v. *General Motors Corp.,* 299 U.S. 3 (1936), that rule is: "Under the established rule, this Court accepts the findings in which two courts concur unless clear error is shown." The rule has been restated many times since the adoption of the Federal Rules of Civil Procedure. See *Graver Tank & Mf'g Co.* v. *Linde Air Products Co.,* 336 U.S. 271, 275 (1949), putting it in terms of requiring "a very obvious and exceptional showing of error;" *Great A. & P. Tea Co.* v. *Supermarket Equipment Corp.,* 340 U.S. 147 (1950); *Berenyi* v. *District Director,* 385 U.S. 630 (1967).

This Court has repeatedly reaffirmed the strength and vitality of the "clearly erroneous" mandate of Rule 52(a), F.R. Civ. P.; indeed, it has done so recently even in direct appeals, without the "two-court rule," see *United States* v. *General Dynamics Corp.,* 415 U.S. 486 (1974); *United States* v. *Citizens & Southern National Bank,* 422 U.S. 86 (1975).

The Government is not offering to show clear error, grievous error, an obvious and exceptional showing of error, or indeed any error at all, in the findings of the District Court; the Government is simply ignoring the District Court's findings and tendering to this Court an allegation that the reinsurance treaty is a sham, a fraud. Its entire argument is built on that premise.

This argument may not be made. The Government should not be allowed to undermine and ignore the

District Judge's findings. It must accept that the *First Railroad* reinsurance agreement is bona fide, is a valid business arrangement, an ordinary and common business transaction, and must make a legal argument based on those findings.

II. The Fifth Circuit in This Case Ignored the Terms of the Statute and Employed a Non-Statutory Test

The issue before the Court is whether Section 801(a) of the Internal Revenue Code is to be applied as written, or whether (as the Government argues) some other test is to be applied to alter and transform the clear statement made by the statute.

Section 801(a) states that an insurance company qualifies as a "life insurance company" if (1) its life insurance reserves as defined,[6] plus

> "(2) unearned premiums, and unpaid losses (whether or not ascertained), on non-cancellable life, health, or accident policies not included in life insurance reserves,"

comprise "more than 50 percent of *its* total reserves (as defined in subsection (c))." (Emphasis added)

The Insurer in *First Railroad,* Georgia Life, wrote both credit life insurance and credit accident and health insurance. For business reasons, it entered into a reinsurance agreement, known in the industry as a Reinsurance Treaty, under which it ceded 60 percent (later 70 percent) of the total accident and health premiums written by it to a Reinsurer. The reinsurance agreement contained terms and rates that (as the trial court found, Pet. App. B 16a), "are usual in the

[6] There is no issue in this case as to the amount of taxpayer's life insurance reserves.

industry between companies dealing at arms length." The premiums on the accident and health insurance were actually transferred to the Reinsurer, Georgia Insurance, as was the liability on the transferred policies. The Reinsurer then established, concurrently with the transfer of premiums, an unearned premium reserve liability equal to the amount of unearned premiums transferred to it.

Georgia Life, having initially set up on its own books an unearned premium reserve of 100% of the total unearned premiums,[7] then—pursuant to state law, Ga. Code Ann. § 56-413(5)—took a deduction on its books for the 60% of accident and health premiums transferred by it to Georgia Insurance. Beyond question, this reduced Georgia Life's actual total reserves to the point that life insurance reserves thereafter comprised more than 50% of its total reserves, qualifying Georgia Life under Section 801(a), unless—as the Government argues and the Fifth Circuit held—the "total reserves" as defined by Section 801(c) must be considered to include the reserves for the unearned accident and health premiums transferred to Georgia Insurance.

Noting that Section 801(a), speaking of the taxpayer (here, Georgia Life), refers to "its" total reserves "as defined in subsection (c)," we turn to Section 801(c) for the definition. It reads:

> "§ 801(c) *Total Reserves Defined.*—
>
> For purposes of subsection (a), the term 'total reserves' means—

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[7] Although Georgia Life actually received much less than the total premiums, since the selling agents (90% of this business was done through agents) retained a provisional commission approximating 50 percent of the premium dollar, Georgia Life was required by state law to set up a reserve liability on its books in the amount of the total unearned premiums. Pet. App. B 11a-12a.

(1) life insurance reserves,

(2) unearned premiums, and unpaid losses (whether or not ascertained), but included in life insurance reserves, and

(3) all other insurance reserves required by law."

To prevail, the Government must demonstrate that the unearned premium reserve for the transferred unearned premiums, which was actually maintained by Georgia Insurance, must somehow be part of Georgia Life's "total reserves," either as "unearned premiums" under clause (2) or as "all other insurance reserves required by law" under clause (3), or perhaps as both.

The Fifth Circuit in this case seems to have adopted a different route. Without directing its attention to either clause (2) or clause (3)—or to Section 801(c) at all, for that matter—the Fifth Circuit first held (Pet. App. A 4a-5a) that because the Reinsurance Treaty provided that losses incurred by Georgia Insurance were generally subject to recapture under the commission scheme set up by the Treaty: [8]

> "In short, the economic substance of the arrangement was that as between taxpayer's issue, Insurer

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[8] As commission for ceding the premiums, the Insurer (Georgia Life) was entitled to a maximum of 96% of the premiums ceded. This maximum commission was then reduced by the amount of losses incurred by the Reinsurer on the reinsured business. Losses incurred during the accounting period could be carried forward as a claim against the Insurer's commission in subsequent accounting periods. The District Judge said (Pet. App. B 13a-14a): "Thus, assuming solvency of Georgia Credit Life, Georgia Insurance would eventually recapture all losses incurred by reason of its assumption of the quota share liability."

suffered or enjoyed fate's capricious precipitation of policy-claims, while the Reinsurer, for a 4% fee, provided in effect a line of credit in case periodic claims reached abnormally high levels. And since the record shows that claim-losses over time averaged only about 22% of total premiums received, there was no likelihood that Reinsurer as an economic matter would ever sustain any losses. Reinsurer under the arrangement did not bear any risks except the outside possibility of insolvency of Insurer. We hold therefore there was no substance to the agreement as reinsurance."

The Fifth Circuit then merely adopted the rationale of the Seventh Circuit in *Economy Finance Corp.* v. *United States,* 501 F.2d 466 (1974), cert. den., 420 U.S. 947, and by applying the risk-attribution test devised in *Economy Finance* found that the accident and health reserves maintained by Georgia Insurance should be attributed here to Georgia Life, destroying its eligibility to qualify as a "life insurance company." The court below said (Pet. App. A 5a-6a):

> "The Seventh Circuit recently considered this credit-insurance reinsurance reserve problem. But they did not reserve the question—they considered very carefully the legislative history of § 801. They concluded that Congress intended by that section to charge the company *actually* experiencing the risk of claim losses with the corresponding 'reserves'—for the purpose of determining who was in the insurance business—as opposed to the loan business.
>
> "We have examined the Seventh Circuit's rationale—as well as Judge Stevens' dissent and the various post-argument papers submitted by all the parties in our case. We think the majority's is the sounder approach—relying as it does on under-

lying Congressional intent and an analysis of the arrangement in the light of practical realities. We accept its reasoning and result."

The Fifth Circuit's decision was a 2-1 majority decision. Judge Roney, dissenting, said (Pet. App. A 6a-7a):

> "I respectfully dissent for the reasons set forth in Judge Aliamo's opinion in this case, and in Judge Stevens' dissent in *Economy Finance Corp.* v. *United States,* 501 F.2d 466 (7th Cir. 1974), cert. denied, 420 U.S. 947, 95 S.Ct. 1328, 43 L.Ed.2d 425 (1975). Had Congress desired to define a life insurance company in terms of the ultimate risk, it could have easily done so. The judicial overlay to that effect is an unnecessary intrusion into the legislative process. Reserves being the lodestar, they should control. Although the majority holds there was no substance to the reinsurance agreement, without even a bow to the clearly erroneous rule, the district court having found factually to the contrary, there was certainly legal substance. The reinsurer was required to commit its assets to reserve status for insurance purposes and to pay tax on the reserve income for tax purposes. It bore all of the legal consequences of required reserves, the reinsured none. This decision throws confusion into a statutory enactment that deserves simpler application."

The opinion of Judge Alaimo (the District Judge), referred to by Judge Roney, is set forth in Appendix B to the petition, pp. 8a-18a. He found that the Reinsurance Treaty was bona fide, a "valid business transaction" entered into "for legitimate business reasons" (p. 17a); he held that Georgia Insurance properly maintained the reserves required to be held against the ceded premiums; and he held that Georgia

Life properly deducted, from its "total reserves," the amount of the reserve liability set up by Georgia Insurance. This qualified Georgia Life as a "life insurance company" under Section 801(a). The District Judge said (p. 16a): "There is irrefutable logic in the assertion that the reserves should follow the premiums."

III. The Determination of Reserves Has Been Committed by Congress to the Law of the States

We may begin, in *First Railroad,* with the following statement of the Fifth Circuit (Pet. App. A 5a):

> "But the issue is not whether the Treaty will be recognized for tax purposes *vel non* but *given* the Treaty, what are its tax consequences and that depends on whether it really amounts to *reinsurance as contemplated in the Act.*" (Emphasis added)

The phrase "reinsurance as contemplated in the Act" is the key to the Fifth Circuit's approach to the case—a federalizing of the issue. The Fifth Circuit seemed to believe that it was interpreting a *federal* phrase, a *federal* criterion. Thus it could say (Pet. App. A 5a): "We hold therefore there was no substance to the agreement as reinsurance," and this permitted it to assert (footnote 8) that the fact that the Georgia state insurance authorities permitted the reserves to be handled as they were, by the Insurer and the Reinsurer, "cannot overcome these economic realities."

But the Fifth Circuit was in error. The word "reinsurance" does not occur in the statute before the Court. The statute does not "contemplate" federal analysis to reject the action of the state authorities, which concededly approved the method employed in

this case. The issue before the Court is the definition of "reserves" in the statute, and that is a matter left by Congress to the states. It is not a federal matter.[9]

If we determine that the question of reserves has been left to the states, two things will stand out as beacons:

1. The District Judge found as a fact (Pet. App. B 16a) that the reinsurance arrangement in this case "was approved by the Insurance Commissioner of the State of Georgia."

2. The Georgia law provides that "full credit shall be allowed a ceding insurer, as an asset or as a deduction from liability, for all reinsurance which may be in effect. . . " Geo. Code Ann. § 56-413(5).

Thus when Georgia Life, the Insurer, took a deduction from its unearned premium reserves for the amount of unearned premiums transferred by it to Georgia Insurance, pursuant to the Treaty, it did so properly under Georgia law; the Government concedes here, brief p. 19, that the Georgia Insurance officials periodically examined the books of Georgia Life and did not challenge this treatment of reserves. As to state law, then, the accident and health reserves were *not* attributable to Georgia Life.

The critical issue in this case is whether the state law treatment of these reserves is conclusive or whether the federal courts may apply some "attribution" or other test to the reserves to make

[9] It is clear that there is no federal law pertaining to insurance reserves; there are no federal requirements as to who is to maintain reserves, or in what amount. The Government has cited no such statute, and none exists.

them appear in some place or in some form other than where they actually are under state law. That is what the Fifth Circuit did in this case, adopting the rationale of *Economy Finance Corp.* v. *United States,* 501 F. 2d 466 (7th Cir., 1974), cert. den. 420 U.S. 947.

There can be no doubt that the law intended by Congress to apply to insurance reserves is the law of the states. As is stated in Denny, Rua and Schoen, *Federal Income Taxation of Insurance Companies* (2d Ed., 1966), p. 5:

> 'Congress has left to the states the determination of the amounts which must be reserved by insurance companies to provide for their liability to policyholders under the various types of contracts written."

The Court of Claims stated it this way in *Alinco Life Ins. Co.* v. *United States,* 373 F. 2d 336 at 345 (1967):

> "Furthermore, Congress has made clear its desire that the insurance industry shall not be regulated by the Federal Government but by the several states. P.L. 15, 79th Cong., 59 Stat. 33 (1945), as amended, 15 U.S.C. Secs. 1011-15. See Dirlam and Stelzer, *The Insurance Industry,* 107 U. of Pa. L. Rev. 199 (1958). Insofar as a state regulatory function is concerned, this court has specifically held that the Internal Revenue Service may not employ the Federal tax laws in an effort to enforce its own concept of what state law should, or should not, be. See *Kirtz* v. *United States,* 157 Ct. Cl. 824, 830, 304 F.2d 460 (1962)."

Indeed, the Congressional intent to rely upon state law is the basic framework of federal insurance company taxation. This is emphasized in this very case

by referring to Treasury Regulations §§1.801-5(a) and (b), defining two phrases in the statute involved here—the phrase "total reserves," contained in Sections 801(a) and 801(c), and the phrase "reserves required by law," contained in Section 801(c)(3). As is seen by a mere glance at those Treasury Regulations, they define those two key phrases of the statute *solely in terms of state law.* Regulations §§ 1.801-5(a) and (b) read in pertinent part as follows:

"1.801-5 *Total Reserves.*

(a) Total reserves defined. For purposes of section 801(a) and §1.801-3, the term 'total reserves' is defined in section 801(c) as the sum of—

(1) Life insurance reserves (as defined in section 801(b) and §-1.801-4),

(2 Unearned premiums (as defined in paragraph (e) of § 1.801-3), and unpaid losses (whether or not ascertained) (as defined in paragraph (g) of § 1.801-3, not included in life insurance reserves, and

(3) All other insurance reserves required by law.

The term 'total reserves' does not, however, include deficiency reserves (within the meaning of section 801(b)(4) and paragraph (e)(4) of § 1.801-4, even though such deficiency reserves are required by State law. In determining total reserves a company is permitted to make use of the highest aggregate reserve required by any State or Territory or the District of Columbia in which it transacts business, but the reserve must have been actually held during the taxable year for which the reserve is claimed.

* * * * * *

(b) *Reserves required by law defined.* For purposes of part I, subchapter L, Chapter 1, of

> the Code, the term 'reserves required by law' means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries."

In an earlier case the Fifth Circuit itself had recognized that state law was binding on federal Internal Revenue officials in the insurance field. *Lamana-Panno-Fallo Industrial Insurance Co.* v. *Commissioner,* 127 F. 2d 56 (C.A. 5th, 1942), held that when a state insurance commissioner interpreted a statute as permitting him to allow industrial insurance companies to hold a lesser amount of reserves than ordinary life insurance companies for a temporary period, and the Commissioner of Internal Revenue refused to allow a deduction for the lesser reserves because (in the Commissioner's opinion) they were not large enough and therefore not "required by law," the Commissioner was wrong. The court stated (127 F. 2d at 58): "We find no provision in Statute or regulation looking to a demand on the Commissioner's part for larger reserves than the state has required."

The dissent in *Economy Finance Corp.* v. *United States*, supra, pointed out that the federal statute committed the determination of reserves to the states, saying (501 F. 2d at 483):

> "Perhaps another test would have been preferable, but the reserve-ratio test does have certain advantages. Insurance companies are regulated by state authorities who require them to maintain adequate

> reserves. There is therefore, an independent basis for believing that the amount of an insurance reserve is a realistic measure of the insurance risks the company has been paid to assume."

And Judge Roney, dissenting in the court below in this case, further pointed out that the state law requirement as to reserves has an independent and substantial economic impact, an impact with real financial bite. Although the majority of the court accepted the Reinsurance Treaty here as being a valid business arrangement but then blandly held that there "was no substance to the agreement as reinsurance" (Pet. App. A 5a), Judge Roney noted (Pet. A 7a) that the effect of that agreement was that

> "reinsurer was required to commit its assets to reserve status for insurance purposes and to pay tax on the reserve income for tax purposes. It bore all of the consequences of required reserves, the reinsured none."

We conclude this demonstration that Congress has mandated that state law should apply, as the basis of federal income taxation of insurance companies, by quoting from hearings on the bill which became the Life Insurance Company Income Tax Act of 1959 (P.L. 86-69, 86th Cong., 1st Sess.), which established the present method of determining the taxable income of life insurance companies. Although that Act "made some dramatic changes in the concept of life insurance company taxation, it made no changes in the definition of 'life insurance company' or of 'life insurance reserves' which have any relevance to" the issues in these cases. *Alinco Life Insurance* v. *United States,* 373 F. 2d 336 at 348-9 (C. Cls., 1967). Congressman

Thomas Curtis (Missouri) of the House Ways and Means Committee said during the hearings on the 1959 Act:

> "I think that we can easily write a tax code if we determine that we are going to regulate the industry at the Federal level. I have resisted that to date because I do not think it is to the good of our society." [10]

No one has contended that the Congress determined that it was going to "regulate the industry at the Federal level." It remains clear that the law of the states controls as to the determination of reserves.

IV. The Phrase "Required by Law" in Section 801(c)(3) Means State Law, and the State Authorities Have Ruled in Favor of the Taxpayer Here

We have shown above that the determination of "reserves" is a general matter committed to the law of the states. We now apply that principle to a particular clause in the statute.

As we pointed out above, p. 21, it would appear to be the Government's burden to deal with the statute by showing that the reserves in question in this case are part of the "total reserves" of Georgia Life under Section 801(c) in one of two ways—as "unearned premiums" under subsection (2), or as "all other insurance reserves required by law" under subsection (3).

This last phrase, "required by law," refers to *state law;* the Government concedes that (brief, pp. 66-67),

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[10] Hearing held by Subcommittee on Internal Revenue Taxation, House Ways and Means Committee, November 17-20, 1958 (85th Congress, 2d Sess.), p. 176.

and we agree, there being no federal law requiring insurance reserves.

At this point, however, the parties part company, because the Government refuses to accept the authoritative actions of the state authorities who interpreted the state law as to "reserves required by law." For No. 75-1260, the *First Railroad* case, this means that the Government asks the Court to ignore the fact that the Insurance Commissioner of the State of Georgia approved the reinsurance arrangement between Georgia Life and Georgia Insurance, approved the establishment by Georgia Insurance of the reserve for the quota share of unearned premiums ceded to it, and approved the deduction by Georgia Life (from its reserves) of that same amount of ceded unearned premiums pursuant to Georgia law. (Pet. App. B 16a) The Government, in other words, asks the Court to ignore the decision of the state authorities that these ceded unearned premiums were *not* included in the reserves of Georgia Life "required by [state] law."

It is a familiar proposition that, in the absence of authoritative judicial decisions, the interpretation of a statute by the administrative agency charged with its enforcement is entitled to great weight. *Trafficante* v. *Metropolitan Life Ins. Co.,* 409 U.S. 250 (1972); *Udall* v. *Tallman,* 380 U.S. 1 (1965); *Skidmore* v. *Swift & Co.,* 323 U.S. 134 (1944); *Norwegian Nitrogen Co.* v. *United States,* 288 U.S. 294 (1933). The Georgia Supreme Court follows the same rule. *Thompson* v. *Eastern Airlines, Inc.,* 220 Ga. 216 (1946). The Government does not challenge this proposition, although it admits without qualification (p. 68) that there "are no decisions of the states' highest courts, or indeed of any state courts, as to whether the tax-

payers were required to establish A & H reserves under state law." How then does the Government argue (as it does, pp 66-76) that the unearned premium reserves for the ceded premiums *were* "required by [state] law" to be included in Georgia Life's total reserves?

The Government cites *Erie Railroad* v. *Tompkins* (304 U.S. 64) cases among others, see brief, p. 67, for the proposition that "in applying substantive federal tax statutes" this Court has disregarded state trial and intermediate court decisions, in the absence of the ruling of the state's highest court, where this Court has concluded that the highest state court would have decided otherwise. A fortiori, it is then argued, this Court may disregard the action or non-action of state administrative officials. If this argument is made in the light of *Trafficante* and the other cases cited in our preceding paragraph as requiring great weight to be accorded the statutory interpretation given by administrative officials, a proposition concurred in by the highest court of the State of Georgia, we take no exception to it. We point out, in addition, that even under the *Erie* doctrine it has been persuasively argued that the actions of state administrative agencies are the "law of the state" for *Erie* purposes. Rosenfield, "Administrative Determinations as State Law Under Erie v. Tompkins," 24 N.Y.U.L.Q. 319 (1949).

All of this, however, becomes irrelevant to the discussion, when we see the basis advanced by the Government for ignoring the action of administrative officials in these cases and for looking elsewhere for what is "required by law." In a statement that we protest vigorously as absolutely unfounded as to *First Railroad,* No. 75-1260, the Government says (p. 68) that

any reliance upon the lack of state administrative action against the taxpayers is particularly unjustified:

> "in the face of the uncontradicted testimony of the state insurance officials in two of the three cases (*Consumer Life* and *First Railroad*) that their failure to require inclusion of the A & H reserves on the taxpayers' annual statements was a consequence of their unfamiliarity with the substance of the arrangements."

As to the *First Railroad* case, this statement is erroneous and without factual basis; it should be stricken as contrary to the record and highly prejudicial. No such statement concerning "unfamiliarity" with these arrangements was made in the *First Railroad* case. Indeed the testimony relied upon in the *First Railroad* case is quoted on the next page of the Government's brief, p. 69, and there it is perfectly clear that the "state insurance official" referred to, the completely discredited Bobby Steed Clark,[11] said nothing at all about "unfamiliarity." He did say that a 1967 Georgia insurance examination report describing the *First Railroad* treaty as in good order was "contrary to all reporting standards and practice," as stated in the Government's brief, p. 69, but this statement by a single employee of the Department is insignificant in view of the finding of the District Court (Pet. App. B

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[11] Bobby Steed Clark is an examiner with the Georgia Department of Insurance, whose zeal to attack the reinsurance treaty led him to testify it was a "guaranteed profit contract . . . a form of surplus aid contract, yes, sir." (App. 136) The district judge himself forced Clark to admit that the *First Railroad* treaty was not a "surplus aid contract," pp. 139-141. Subsequently, the Government put on an expert witness, Professor Robert E. Zelten of the Wharton School, who testified (App. 163): "This is not a surplus aid contract. There is no way in the world it will work out that way."

16a) that the treaty was approved by the Insurance Commissioner of the State. Indeed, we may compare the testimony of the Senior Examiner of the Department, Mr. Lawrence Earls, who signed a 1964 report on the same treaty (App. 147, 150). Mr. Clark was forced to admit that he had not read Mr. Earls' report (App. 147, 150), although he knew Mr. Earls "did make that examination" (App. 147), and that he had been informed that the report "said that the contracts were reviewed and were in good order." (App. 150) Mr. Earls testified that the determination he made at that time ("and I think it was a correct determination") "was that this treaty did have economic reality." (App. 151-2) Mr. Clark then testified, weakly: "I never questioned that Mr. Earls went into the contract, sir." (App. 152)

For the Government's brief to have put Bobby Steed Clark forward as "the state insurance official" was bad enough; that the Government cited Mr. Clark's testimony against the reinsurance treaty, in the face of the District Court's specific finding that the treaty was bona fide, served business purposes, and had been approved by the Insurance Commissioner, was worse; but for the Government to have cast Mr. Clark's testimony in terms of the "unfamiliarity" argument was beyond the pale. As to *First Railroad*, this portion of the Government's brief should be stricken.

V. The Phrase "Unearned Premiums" in Section 801(c)(2) Means Actual Sums of Money, Not Reserves

If the reserves (of Georgia Insurance) sought here by the Government to be attributed to Georgia Life, the Insurer, are not part of Georgia Life's total reserves by virtue of Section 801(c) (3), "all other insurance reserves required by law," they must—if the Govern-

ment's argument is to prevail—be "unearned premiums" under Section 801(c)(2). And indeed the Government so argues, pages 38-41 of its brief.

It is actually somewhat embarrassing to read the Government's attempt on those pages to prove that the term "unearned premiums" contained in the definition of "total reserves" in Section 801(c)(2) does not mean actual premium dollars on hand but instead means reserves—that is, the term should be read as saying "unpaid premium reserves." The Government's brief admits (p. 41), rather awkwardly, that Congress did somehow omit to use the word "reserves" in subsection (2) of Section 801(c), in defining "unearned premiums," although it used the word "reserves" in both the other subsections; the brief says that this omission is of no consequence; and it offers as the "most likely explanation" for this admitted failure the idea that in effect everybody in the insurance business views the term "unearned premiums" as connoting the reserves for those items.

That would be news, we think, to those who view the actual dollars of unearned premiums as the source of the funds from which to pay the claims stemming from the policies which are the source of the premiums. A company pays claims from actual funds, not from book figures. But a more direct obstacle stands in the way of the Government's bland attempt to add a crucial word to this important definition. That obstacle is Treasury Regulation § 1.801-3(e), defining "unearned premiums" as follows:

> "*Unearned premiums.* The term "unearned premiums" means *those amounts* which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance.

> Such term includes all unearned premiums, whether or not required by law." (Emphasis added)

The Regulation is not mentioned at all in this portion of the Government's brief, and with good reason—the Regulation is totally inconsistent with the Government's argument (brief, p. 40) that the term "unearned premiums"

> "does not, as the Court of Claims erroneously believed, refer to the actual premium dollars on hand during the period of coverage."

Those actual premium dollars are the "amounts" mentioned in the Regulation; they were possessed in this case by Georgia Insurance, not Georgia Life; and thus they cannot with regard to Georgia Life be the "unearned premiums" mentioned in subparagraph (2) of Section 801(c), as part of Georgia Life's "total reserves."

Confirming and strengthening this point is another of the Government's regulations, Treasury Regulation § 1.801-5(a) which defines "total reserves." The second paragraph of Regulation § 1.801-5(a) reads as follows:

> "The term 'total reserves' does not, however, include deficiency reserves (within the meaning of section 801(b)(4), and paragraph (e)(4) of § 1.801-4), even though such deficiency reserves are required by State law. In determining total reserves, a company is permitted to make use of the highest aggregate reserve required by any State or Territory or the District of Columbia in which it transacts business, but the reserve *must have been actually held during the taxable year for which the reserve is claimed."* (Emphasis added)

The Government's "risk-attribution" test cannot be squared with the requirement of Regulation §1.801-5

(a) that the reserve "must have been actually held during the taxable year." Only one company in this case, Georgia Insurance, "actually held" the unearned premiums; only that company can under the Regulation legally claim the reserves for those unearned premiums; and it is not legally possible for the Government to attribute those reserves to Georgia Life, which did not hold them. The Regulation cuts both ways.

Precisely the same thing is true of the requirement of Treasury Regulation § 1.801-5(b), supra, that the term "reserves required by law" means reserves "which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries." Only one company here—Georgia Insurance—fits under that Regulation, and it is not legally possible for the Government to attribute the "reserves required by law" to Georgia Life. That Regulation, too, cuts both ways.

It is remarkable but true that the Government's brief does not cite, does not even print, Treasury Regulation §1.801-5(a) which contains the requirement that the reserve "must have been actually held." Nor does the Government discuss or even refer to the requirement of Regulation § 1.801-5(b) that "reserves required by law" must have been reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries." [12] Obviously

[12] The Government's brief does print Regulation § 1.801-5(b) and does actually argue that its definition of "total reserves" helps the Government's case (brief, pp. 66-67), but a glance at the argument reveals that the Government has referred to only one portion of that Regulation and has completely omitted to deal with the portion quoted above.

these regulations are inconsistent with a reserves-follow-the-risk rule that ignores the actual facts of which company actually held the reserves and which company reported the reserves in its annual statement and had them accepted by state regulatory authorities.

The Government is bound by its own regulations. This principle, articulated in *Accardi* v. *Shaughnessy,* 347 U.S. 260 (1953), *Service* v. *Dulles,* 354 U.S. 363 (1957), and *Vitarelli* v. *Seaton,* 359 U.S. 535 (1959), was dramatically reaffirmed in *United States* v. *Nixon,* 418 U.S. at 683 at 695 (1974), in which the Court said: "So long as this regulation is extant it has the force of law."

VI. The Risk-Attribution Test Cannot Be Justified by Presumed Congressional Intent

It appears to be agreed that the only direct legislative history concerning the 50 percent reserve-ratio qualification requirement of Section 801(a), which has been contained in the tax statutes since 1921,[13] is found in the following testimony of the Tax Advisor to the Treasury Department (Dr. T. S. Adams) in hearings in 1921:

> "Some companies mix with their life business accident and health insurance. It is not practicable for all companies to dissociate those businesses so that we have assumed that if this accident and health business was more than 50 percent of their business, *as measured by their reserves,* it could not be treated as a life insurance company. On the other hand, if their accident and health insurance were incidental and represented less than 50 per-

[13] The history of the section is traced in detail in *Alinco Life Insurance Co.* v. *United States,* 373 F. 2d 336 (C. Cl., 1967).

cent of their business we treated them as a life insurance company." [14] [Emphasis supplied].

As was said in the *Alinco* case, 373 F.2d at 347, commenting on this testimony:

> "Thus, it was the character of an insurance company's business *as measured by its policy reserves* that served as the touchstone for the definition of 'life insurance company'." [Emphasis supplied]

The words "its policy reserves" point up that Section 801(a) specifically says that the 50 percent test, when applied to the company seeking to qualify as a life insurance company, relates to "its" total reserves. The word "its" seems clear, but the court below refused to apply it and instead looked to the reserves of another company—Georgia Insurance. In doing so, the court said it was basing its actions on presumed Congressional intent—an intent that "the company *actually* experiencing the risk of claim losses" be charged with the corresponding reserves. (Pet. App. A 6a)

But the Fifth Circuit, in *First Railroad,* did not make an independent examination of the Congressional intent. Nor did it find the "risk" test set forth in the statute; concededly, it is not mentioned in the statute, directly or indirectly. Nor is the "risk" test as such to be found in the legislative history. Instead, the Fifth Circuit "examined the Seventh Circuit's rationale" in the *Economy Finance case*, 501 F.2d 466 (1974), cert. den., 420 U.S. 947, accepted the majority opinion as "the sounder approach—relying as it does

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[14] Hearings on H.R. 8245, Internal Revenue, Senate Finance Committee, 67th Cong., 1st Sess. (1921), p. 85.

on underlying Congressional intent and an analysis of the arrangement in the light of practical realities," and said: "We accept its reasoning and result." Pet. App. A 6a. Thus the Fifth Circuit refused to apply the literal terms of the Statute.

Four months later, in *Penn Security Life Ins. Co.* v. *United States,* No. 75-1285, the Court of Claims *did* make an independent examination of the Congressional intent. It disagreed with the Seventh Circuit that the dominant objective of Congress, in enacting the reserve-ratio test of Section 801(a), was to deal with investment income generated in much life insurance. It found no evidence in the legislative history that Congress was primarily concerned with investment income when it enacted the statute. The lucid and convincing analysis of the Court of Claims, see No. 75-1285, Pet. App. 16a-18a, doing what the Fifth Circuit had failed to do, goes far to destroy the *Economy Finance* conception that the literal interpretation of the statute is not an acceptable approach.

Indeed, a totally different explanation for the *Economy Finance* result is not hard to find. In that case, there was not (as in the case at bar) an arms-length reinsurance agreement usual in the industry. There was, instead, an agreement under which the taxpayers (reinsurers, in that case) required the ceding company, which maintained the unearned premium reserve, to invest most of those premium reserves in subordinated debentures of the parent of the taxpayers; it was also required to turn over the interest income received on those debentures as an "additional commission" to a partnership composed of persons related to the taxpayers. See 501 F.2d at 470. Therefore, as the Court of Claims pointed out in the *Penn Security* decision,

Pet. App. 16a, "the *Economy Finance* taxpayers in effect received the proceeds of the unearned reserves even while in the hands of the ceding company." This arrangement could, as the Court of Claims said, be construed as making the ceding company the agent of the taxpayers. Cf. *Superior Life Ins. Co.* v. *United States,* 462 F.2d 945 (4th Cir., 1972), where the relationship between the parties was found to be not arms-length but a mere agency.

A mere agency, also, is contained in the simplistic example given on page 36 of the Government's brief.[15] That example has no relation to the *First Railroad* facts, an arms-length transaction, where (as the dissenting judge in the Fifth Circuit pointed out, Pet. App. B 7a) many legal consequences—including income tax liability—*do* flow from the transfer of the unearned premiums under the Reinsurance Treaty in this case, and the establishment of a reserve by Georgia Insurance.

To use the phrase of the Court of Claims in No. 75-1285, the *Penn Security* case, we take vigorous objection to the attempt to attribute to the Insurer "unearned premium reserves which it was not required to hold, had no right to hold, and did not in fact hold." *Penn Security,* Pet. App. 13a, and to do this on the basis of a presumed Congressional intent, contrary to the express provisions of the statute.

[15] A, who has accounts receivable, engages B to collect them, to pay obligations and to remit the balance to A. The receipts and disbursements are attributable to A, notwithstanding B's physical possession of the fund. Any reserve for bad debts would be that of A. The example is advanced to bolster the Government's argument that physical possession of the unearned premiums is irrelevant to the legal consequences of such possession, because B is merely the agent of A.

As Judge Roney, dissenting in the court below in this case, put it (Pet. App. A 7a):

> "Had Congress desired to define a life insurance company in terms of the ultimate risk, it could have easily done so. The judicial overlay to that effect is an unnecessary intrusion into the legislative process. Reserves being the lodestar, they should control . . . This decision throws confusion into a statutory enactment that deserves simpler application."

And the dissent in *Economy Finance,* the case in which the Government's "risk" test was first accepted, expressed its disagreement with that test in this fashion (501 F.2d at 483):

> "Congress could have selected any one of several different tests for deciding when the life insurance portion of a company's business is sufficient to characterize the enterprise as a 'life insurance company' for tax purposes. It might have used the number of life policies written, the amount of premium income, the face value of its policies, or possibly some combination of different yardsticks. Instead, it chose to attach significance to the relative importance of the company's life insurance reserves.
>
> "Perhaps another test would have been preferable, but the reserve-ratio test does have certain advantages. Insurance companies are regulated by state authorities who require them to maintain adequate reserves. There is, therefore, an independent basis for believing that the amount of an insurance reserve is a realistic measure of the insurance risks the company has been paid to assume. For the reserve is not appropriate until the company (a) has assumed the risk, and (b) has been paid for assuming that risk. The amount which it is paid, usually in the form of a premium

which has not yet been earned because it applies to future risks, provides the company with the wherewithal to acquire the assets to hold in reserve.

"The test supplied by Congress to identify a life insurance company is a rather simple one and, as I understand it, these taxpayers passed it."

The irony of the Government's argument will not be lost on the Court. On the one hand, the Government argues that Congress in Section 801(a) established an "objective" mathematical test to determine the qualifications of insurance companies to be classified as life insurance companies. (Brief, pp. 30, 46) But on the other hand, the entire basis of the Government's argument is that the objective test prescribed by the statute (the test of which company *actually* maintains the reserves) fails to give the "correct" answer and therefore a risk-attribution test must be applied, in order to change the actual facts and obtain a result claimed to be what Congress would have desired had it understood the situation.[16]

VII. Risk-Shifting Is Not the Only Purpose of Reinsurance and Was Not in This Case

The Government's entire argument is based on the premise that reinsurance has only one purpose—the shifting of risk. But the "proof" of this statement has to do with *insurance.* Thus the Government says, p. 31, that "the essence of insurance is risk-shifting," referring to *Helvering* v. *Le Gierse,* 312 U.S. 531, and

[16] This indeed was the rationale of the Seventh Circuit's decision in *Economy Finance.* The court admitted, 501 F. 2d at 477, that it was refusing to apply a "literal interpretation" of the statute, and the Fifth Circuit in this case simply adopted the *Economy Finance* rationale.

again on page 43 it quotes from the *Le Gierse* case: "Historically and commonly insurance involves risk-shifting and risk-distributing."[17] The clear message of the Government's argument is that if the reinsurance agreement involved in this case does not shift the risk from the insurer to the reinsurer, it is not "insurance" and does not have an insurance purpose. Indeed, the Government's brief (p. 63) asserts that the Treaty II type of reinsurance arrangement, under which it classifies *First Railroad,* is not reinsurance at all.

There is simply nothing to this argument of the Government. There are many purposes to reinsurance which do not involve risk-shifting. An article by John V. Smith entitled "The Financial Effect of Reinsurance," contained in Management Bulletin 39 of the American Management Association (an issue devoted to "Reinsurance: Methods, Markets, and Economies"), sets out eleven separate uses of reinsurance. A number of these uses are present in *First Railroad,* as we shall demonstrate.

The testimony in this case is to the same effect. The expert witness Arthur Crooks Eddy, a well-known actuary who specializes exclusively in insurance companies and has done so for over 25 years (App. 106-7), was asked by Government counsel to accept the proposition that "the only basic purpose of reinsurance is to

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[17] The quotation is accurate, but the *LeGierse* case has nothing to do with the issue at bar. It involved the question whether a single-premium life policy (bizarrely taken out by an 80-year-old woman at the same time she took out an annuity contract with the same company) was "insurance" for the purposes of estate tax. The Court held that the two policies together canceled any insurance risk by the company.

spread the risk on the loss." (App. 123) Mr. Eddy refused, saying: "There are many reasons for reinsurance, some of which we have heard discussed here today, other than spreading of risk." And compare *Alinco Life Ins. Co.* v. *United States,* 373 F.2d 336, 342 (C. Cls., 1967): "However, the [Government's] non sequitur is obvious when it is realized that an insurance company's decision to reinsure is not invariably based on actuarial need."

The District Judge, it will be recalled, found that despite a transfer of minimal risk under the Reinsurance Treaty, "there were substantial non-tax purposes for entering into the arrangement." (Pet. App. B 14a) These "non-tax" reasons are *insurance* reasons, reinsurance purposes, inherent in the nature of the insurance industry. We proceed to discuss those reasons.

One principal purpose found by the trial court was that reinsurance permitted Georgia Life to expand its accident and health business. (Pet. App. B 14a) This point requires explanation. The Georgia insurance authorities (like those in many other states) had a policy of preventing an insurance company from writing more business when its ratio of net written premiums to policyholder surplus exceeded two to one. The reason for this policy, obviously, was that the surplus (the funds from which claims would be paid) would be running low and might be rendered inadequate. Yet the surplus was depleted every time an accident and health policy was written, because while the company actually received only fifty cents of every dollar written (after deduction of the agent's commission), the company was required by state law to reserve one full dollar for each dollar written, thus increasing its liabilities as it increased its business. Be-

ing a fledgling insurance company with a small surplus, just starting out in the accident and health insurance field, Georgia Life (as the District Judge stated, Pet. App. B 14a) soon realized that the more business it wrote, the more its surplus was being burdened.

The former president of Georgia Insurance, Mr. Herbert Parks, explained the two-to-one ratio in the following colloquy with counsel (App. 91):

> "Q. What is the significance of that ratio?
> A. Well, to the Insurance Departments and others who judged your statement, it was an indication of solvency; ability to stand up to your liabilities.
>
> Q. Were you ever specifically prohibited or cautioned about further expansion because of this ratio?
> A. Well, we weren't specifically cautioned about further expansion, but we were cautioned not to overwrite.
>
> Q. What would a satisfactory ratio have been?
> A. The Insurance Department felt that as long as you were writing one-and-a-half in net written premiums and one-and-a-half times your policy holders surplus, that you were on firm ground. They might let you go to two. If you went beyond two, they would come in and stop you from writing additional business.
>
> Q. The Insurance Department of the states?
> A. Yes, that's right. To a large degree, that rule is still invoked by a number of states."

As the Government's own expert witness, Professor Robert Zelten, testified (App. 163): "The basic reason why 2 to 1 is so important is that the expansion of business creates a drain on surplus."

By having a reinsurance company underwrite a major share of that business (70 percent after the first year), Georgia Life was able to add the large surplus of the reinsuring company to Georgia Life's own small surplus for that quota share. Having thus eliminated the two-to-one ratio problem, at the cost of a 4 percent reinsurance commission, Georgia Life could continue to write increased business. "The result was," as the District Judge found, "that Georgia Credit Life was thereafter capable of, and in fact accomplished, a threefold increase in the volume of credit accident and health business." (Pet. App. B 15a)

This expansion of business, made possible by the Reinsurance Treaty in this case, had still another great advantage—another (non-tax) insurance reason. As the former president of Georgia Life (Mr. E. Russell Phillips) testified, insurance is "a matter of numbers . . . the more numbers you insure, the more your results tend to stabilize." (App. 84) The District Judge, saying that loss experience in the credit accident and health industry is based upon average loss experience, put it as follows: "The reliability of these averages improves with an increase in the number of persons covered by a particular company." (Pet. App. B 15a, footnote 7) Thus it was important to the stabilization of Georgia Life that it expand its accident and health business, and the reinsurance arrangement made this possible.[18]

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[18] The expert, Arthur Crooks Eddy, explained it this way (App. 113): "The base is the number of people. You have only got 30% of each guy under this arrangement, but that allows you to have 3⅓ guys for the same dollar, which is what we work with in the insurance business or the laws of averages, and they don't—they don't hold as well with small numbers as with larger ones."

Still another non-tax (insurance) reason for the reinsurance agreement was spelled out by the District Judge in his Findings of Fact. He pointed out (Pet. App. B 15a) that it "tended to insure the solvency of Georgia Credit Life by protecting its surplus from depletion through payment of excessive losses." The reason was that if Georgia Life had excessive losses, those losses would not have to be paid initially by Georgia Life out of its small surplus; instead, the losses "would be satisfied initially from the excess surplus held by Georgia Insurance." And while these losses would eventually be recaptured, the recapture would not involve any surplus drain to Georgia Life, but only an adjustment to the commissions to be paid to it by Georgia Insurance. "Thus," the District Judge stated (p. 15a), "the capital structure of Georgia Credit Life was insulated against the risk of excessive losses and in such event the company would remain solvent enabling it to recoup commission losses through retroactive adjustment of provisional commissions paid to its agents."

Another obvious non-tax benefit of the Reinsurance Treaty, found as a fact by the trial judge (Pet. App. B 15a), was that it subjected "the substantial surplus" of Georgia Insurance to policyholder claims. This was "a particularly valuable protection," should Georgia Life become insolvent, because there was an insolvency clause (required by state law, as the trial judge found, Pet. App. B 15a) in the Reinsurance Treaty which provided for continued liability of Georgia Insurance for 70 percent of the claim.

The Government's idea, then, that a reinsurance agreement that does not shift the risk is not reinsurance at all, and is in fact a sham, is seen to be entirely

without merit. We do not concede that there was an absence of risk to Georgia Life in this case; the record in fact reveals a considerable degree of risk;[19] but risk-shifting is not the only reason, perhaps is not a reason at all, for entering into a reinsurance arrangement.

The Government in its brief, p. 20, says that "the presidents of Georgia Insurance and Georgia Life acknowledged that the tax considerations played a role in the decision to enter into the reinsurance arrangement." A glance at the references will indicate that the Government has given undue emphasis to this point, but even if the Government were correct, the District Judge's findings make clear that the business purposes of the reinsurance agreement were the major considerations. Directly applicable here is the statement of the Court of Claims in *Alinco Life Insurance Co.* v. *United States*, 373 F.2d 336, 346 (1967):

> "The tax advantages which may flow from being taxed as a life insurance company were undoubtedly considered in working out this transaction, but they were secondary in importance to the business purposes and Judge Learned Hand long ago reminded us that:
>
> 'Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody

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[19] There were actual losses in excess of 96 percent of total premiums in the case of individual insurance agents. (App. 74) Georgia Life actually had *operating losses* in accident and health insurance during each of its first four years of selling such insurance. (App. 99; see P. Ex. 23, App. 195, for statement of losses in three of those years). At the time of entering into the reinsurance agreement, the officials of Georgia Life regarded insolvency as a "very real and present risk." (App. 74; see also App. 104).

> does so, rich and poor; and all do right, for nobody owes any public duty to pay more than the law demands; taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.' Commissioner v. Newman, 159 F.2d 828, 850 (2nd Cir. 1947). (dissenting opinion), cert. denied, 331 U.S. 859."

Indeed, the fact that tax considerations play a role—a legitimate role—in business decisions is a fact of everyday life, recognized as perfectly proper by the courts so long as the transactions are not sham or devoid of business purpose. The Fifth Circuit in its decision below thought it necessary to say (Pet. App. A 5a):

> "We in no way denigrate the salutary holding of *Gregory* v. *Helvering*, 1935, 293 U.S. 465, 55 S. Ct. 266, 79 L.Ed. 596, that taxpayers are free to arrange their affairs in a way that entitles them to tax advantages."

As the Court of Claims said in *Alinco Life Insurance Co.*, supra, 373 F.2d at 343: "Yet, even a 'major motive' to reduce taxes will not vitiate an otherwise valid and real business transaction. *United States* v. *Cumberland Public Service Co.*, 338 U.S. 451, 455 (1950)." Even where tax avoidance or minimization is (unlike the case at bar) the only purpose for the transaction, it has been held that the transaction may not be disregarded solely because of that fact. *Kraft Foods* v. *Commissioner,* 232 F.2d 118 (2d Cir., 1966). A fortiori, the transaction in the case at bar presents no problem, in view of the District Court's findings.

VIII. The Insurance Industry Has Been Shaken by the Questions Stemming from the "Risk-Attribution" Test

We end our discussion by pointing out that the insurance industry has been thrown into consternation by the "risk-attribution" test contended for here by the Government. For example, an article in *Best's Review* for September, 1975 ("Questions Again Arise Concerning the Qualification of Credit Life Insurance Companies for Federal Income Tax Purposes," by Lenrow, Milo, and Zampino, p. 68), discussing these cases, points out that the use of the risk-attribution test involves not only the qualification vel non of companies under Section 801(a), tremendously important in its own right, but also other questions under the Internal Revenue Code. As the authors say, pp. 76-77:

> "The issue is extremely complex. The main difficulty of the 'risk attribution' principle is that it leaves many important questions unanswered.
>
> (a) If certain reserves of A are attributable to B for qualification purposes, are these same reserves then removed from A's qualification ratio?
>
> (b) If such reserves merely succeed in disqualifying B, would the end result be to disqualify B's actual income (solely from life insurance sources) from life insurance tax treatment or to leave the income from these 'non-life' reserves in A, where it could be subject to the favorable life insurance tax treatment?
>
> Not only are the answers complex, but the confusion that could surround the application of such answers could lead to further confusion."

Still other problems are suggested by the Court of Claims in its *Penn Security* decision involved in these

cases. Criticizing the importation by the Seventh Circuit of the risk-attribution test into a statutory scheme that does not mention it, the Court of Claims said (No. 75-1285, Pet. App. 18a; 524 F. 2d at 1163) of the *Economy Finance* approach followed in *First Railroad* by the Fifth Circuit:

> "In addition, the consequences of the general rule laid down by the Court of Appeals are uncertain and unclear. Judge Stevens thought the majority's standard might well exclude from coverage under § 801 such a common form of life insurance as term insurance. See 501 F. 2d at 486 n.7. There may be other untoward gaps or disharmonies. We cannot tell because the consequences of departing from the text of § 801 are opaque."

IX. Conclusion

We have been able to construct no better answer to the Government's argument for ignoring the literal words of the statute, and instead applying a risk-attribution test, than the dissent in the *Economy Finance* decision. We close by quoting the last paragraph of that dissenting opinion (501 F. 2d at 485-6):

> "In sum, I am persuaded that the government's conclusion that life insurance represents less than half of taxpayers' total insurance business rests on a non-statutory standard. Congress may have acted unwisely in giving preferential tax treatment to life insurance companies, and it may have been unwise to select a reserve-ratio test as the definition of a life insurance company for tax purposes. Nevertheless, we must, of course, apply the test which Congress has specified."

We ask that the decision of the Fifth Circuit in this case be reversed and the decision of the District Court be reinstated.

Respectfully submitted,

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